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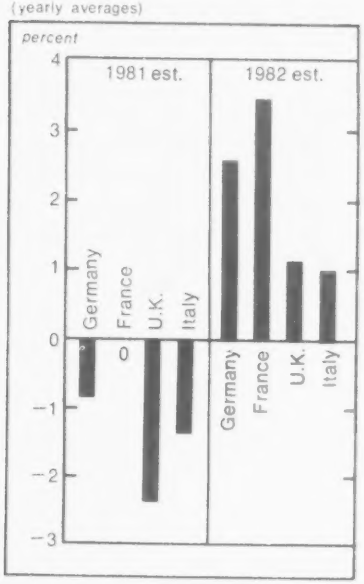
Waiting for the European Turnaround

European economic recovery has been delayed. Earlier this year it appeared that most European economies would have turned around by mid-summer. But mid-summer has arrived, and prospects now are that Europe as a whole will not show positive economic growth before the fourth quarter. The course of recovery from the current recession—now five quarters old—will be shallow in its initial stages, with the pace of growth not becoming robust much before next summer. Nonetheless, the below-trend increases in real output projected for 1982 on a year-over-year basis give something of a distorted picture. Measured from the fourth quarter of 1981 to fourth-quarter 1982, real output in Europe seems likely to increase at something like a 4% rate.

European real GNP growth rates
(yearly averages)



The major economies are relatively unsynchronized. France is widely expected to lead the rest of Europe, but the effects of the reflationary fiscal and wage policies of the Mitterrand government may prove to be largely offset in the short run by a plunge in business investment and further reductions in inventories. The outlook for Germany is even more uncertain. Foreign orders have surged since the autumn of 1980, and the growth of net exports has been sufficient to keep real GNP roughly stable over the first half of 1981 in spite of declines in virtually every component of real domestic demand. Nonetheless, inventories remain very high, private consumption demand is likely to be flat or declining in real terms through yearend, and construction remains extremely depressed. The U.K. growth outlook continues disappointing, although the long contraction of the British economy should come to an end this summer as inventory depletion ends. Italy appears likely to be the slowest to recover. The Italian economy is currently extremely weak because of the tight credit conditions made necessary by a worsened balance of payments earlier this year. Prospects for significant growth next year depend on a strong export recovery.

A major cause of this delay in recovery of the European economies is the restrictive monetary policies adopted by European monetary authorities in response to renewed dollar strength. Given the prospect of no relaxation in the current thrust of U.S. monetary policy—and the concern of most European policymakers with preventing a resurgence of inflation—a general shift to markedly more expansive policies in Europe does not appear likely next year. This implies that recovery in Europe will be relatively slow to acquire momentum. But it would also seem to imply that the recovery will be more durable.

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German trade balance poised for sharp upturn.

Germany's trade balance appears set for substantial improvement, with export orders surging and domestic orders remaining flat. The heightened competitiveness of exports stems from the decline in the mark's foreign-exchange value. The volume of export orders in April-May was up 22% from its cyclical low in August-September of last year, despite the continued weakness of Germany's major trading partners in the European Community. The improved order position has begun to translate into actual exports, with export volume in the first quarter of 1981 up 8%, on a seasonally adjusted quarterly basis. The seasonally adjusted trade balance showed a surplus of 2.6 billion DM in April-May, compared with a surplus of only 110 million DM in January-February and one of 1.2 billion DM in April-May 1980. As Germany publishes seasonally unadjusted trade and current-account numbers, data published in the next several months, reflecting seasonal outflows from expenditures on tourism, are likely to mask the extent of the underlying improvement and may delay a favorable reassessment of the mark by the world's foreign-exchange markets.

Italy's new government seeks public spending cuts.

Italy's new government has agreed to postpone spending of some 8 trillion lira to bring the public-sector borrowing requirement—now running at an annual rate of 50 trillion lira—nearer to its target of lit.37.5 trillion. Most of the postponed expenditures require parliamentary approval, however, which is uncertain. Italy's large budget deficit forces the Bank of Italy to choose between tightening credit to the private sector or allowing too rapid a rate of monetary expansion. So far, the central bank has leaned toward restricting private-sector credit, the latest evidence of which is a 30% import deposit scheme that requires importers to deposit 30% of the value of imports (excluding oil and wheat) interest-free with the Bank of Italy for three months. A large reduction in the public-sector borrowing requirement would permit some easing of credit to the private sector while maintaining money stock growth within acceptable limits.

Portugal adopts austerity policies to check a widening current-account gap.

A worsening balance-of-payments position is beginning to constrain Portuguese efforts to sustain an investment-led economic recovery. Official policies in 1980, a double election year, were basically successful, with real GDP growth of 5%, investment expansion of 8%, and a fall in the rate of inflation. The current account did, however, deteriorate, posting a deficit of $1.2 billion for the year. It has now become clear that expansionary policies cannot be sustained in 1981 with the world recession stifling export growth and a severe drought hampering both agricultural production and the output of hydroelectricity. Accordingly, to limit this year's current-account deficit to $1.7 billion, the government has put on the brakes. Spending by government departments and state enterprises has been cut, oil prices raised, interest rates increased for the first time in four years, and curbs placed upon foreign borrowing. The government does not, however, see these measures as representing a major setback to the new 1981-84 medium-term development plan.

Ecuador feeling the effects of weak world oil price.

Ecuador's oil export income in the first half of 1981 was down some 6% from its year-earlier level, owing to lower world oil prices. Crude export prices have fallen to $32 per barrel from $39 earlier this year. The fall in oil income is coinciding with weak prices and declining export revenue from Ecuador's other major commodity exports—bananas, coffee, cocoa, and sugar. Indeed, total exports for the January-June period were 8.5% below 1980, while imports were up 2%. The result is a less-than-anticipated level of foreign-exchange earnings—international reserves fell $260 million between end-1980 and May—and government budget income. This has prompted the government to reassess its financial and fiscal plans. Accordingly, government expenditure is being curtailed and more rigorous tax collection is being pressed. It is hoped that these adjustment actions will offset part of the loss of oil income.

Chile's exchange-rate policy brings lower inflation but a larger current-account deficit.

Chile has made remarkable progress on the inflation front since its adoption of a fixed exchange rate two years ago, but its current-account position has deteriorated. The consumer price index rose at an annual year-over-year rate of 21% in June, versus 38% in June 1980. If the small monthly increments in price rise registered in the first half are sustained, Chile's inflation rate will be less than 15% by yearend. The fixed-exchange-rate policy, however, has led to a significant rise in imports that has not been matched by a similar rise in exports. Indeed, in the January-April period, imports rose 47%; exports declined 16%, with mining export sales down 22%, owing to lower world mineral prices, and industrial product sales off 7% because of the reduced competitiveness associated with an appreciated real exchange rate. Based on this performance, Chile's current-account deficit is projected to widen to $3.2 billion in 1981 from $1.8 billion last year.

IMF steps up assistance to Thailand to help finance large and growing payments gap.

The new standby arrangement between Thailand and the IMF authorizes credits of 814.5 million SDRs ($925 million at the current exchange rate) to be drawn over a two-year period from mid-1981 to mid-1983. This precedent-setting figure is equivalent to 300% of the Thai quota of 271.5 million SDRs. Thailand's borrowings from the IMF have been rather small until now—obligations to the Fund in June were only SDR 109.1 million—but a widening balance-of-payments deficit has necessitated increased reliance on the IMF. Thailand's current-account deficit may exceed $3 billion this year, a result of rising oil prices, fiscal deficits, and inflation. The new IMF standby calls on the Thai government to take additional measures to boost energy prices, provide agricultural production incentives, and reduce the level of protection of certain industries. Since the standby's announcement, interest rates have been raised and the baht has been devalued 8.7%, measures undoubtedly supported by the IMF.

Papua New Guinea squeezed by weak commodity export prices and high imports.

The economy of Papua New Guinea is currently suffering the balance-of-payments maladies of all non-oil-exporting developing countries—export weakness coupled with rising import costs. The softness of world commodity prices led to a 2.1% drop in exports last year, in nominal terms, while imports soared 25.9%. The result was a deficit in goods and services of $423 million (some 16% of GDP), made up partly by Australian aid and by heavy commercial borrowing; $175 million in syndicated loans was raised in 1980-81. Given Papua New Guinea's vast mineral and agricultural resource potential—which underpinned these private credit extensions—its long-term economic prospects are undoubtedly bright. Short-term prospects, however, are less certain. The economy's performance in the short run depends on world commodity market conditions and on the timing and productivity of such investment projects as the Ok Tedi gold and copper mine currently under way. It also depends on whether the government decides to maintain the prevailing "hard kina" policy or replace it with a more flexible exchange policy to aid the trade balance.

Libya resisting substantive cuts in oil prices.

Libya, whose oil exports are traditionally the highest priced of any OPEC member, is facing increasing pressure to cut its official oil prices in view of the worldwide oil glut. On July 1, Libya reduced its official price by $1 per barrel to $40, the same as Algeria and Nigeria. But the $40 per-barrel price is still $5 above similar U.K. North Sea crudes and $8 above the Saudi benchmark price. As a result, oil companies have sought other sources of supply, causing Libya to reduce its production to one million barrels per day from the 1980 daily average of 1.8 million barrels. Libya's ambitious development program, however, is unlikely to be adversely affected. It is estimated that Libya needs the revenue from only one million barrels per day this year—some $13-$14 billion—to proceed with its development plans. And even in the event of an oil-revenue shortfall, Libya possesses reserves sufficient to cover a full year's foreign-exchange requirements.

Social Security: A Quick Fix or a Cure?

There is no denying that America's Social Security system is in trouble. Just how serious that trouble is now ranks as one of the most heated political issues in Washington. The outcome of the current debate will have profound implications for the system's survival—both in the short run and for the longer haul.

Much of the current controversy has focused on the impending threat to the system's financial viability. Social Security trustees have projected that unless steps are taken to change the current law, the Old Age and Survivors Insurance (OASI) Trust Fund—the largest of the three Social Security trust funds—will be exhausted in the latter half of 1982. Responding to this gloomy prediction, the Reagan administration has recommended the elimination of the so-called minimum benefit, as well as some other changes designed to curb system outflows, including a reduction in benefits paid those opting for early retirement. Opponents of the Reagan cost-cutting proposal have downplayed the significance of the depletion of the OASI Trust Fund. Using somewhat more optimistic economic assumptions, they argue that changing the law to allow borrowing from the other two trust funds would avert the short-term financial crisis until the scheduled 1985 tax increases begin replenishing reserves.

The short-term financial health of the Social Security system is indeed critical—not only to the millions of retired Americans who depend upon their monthly checks from the government's largest income transfer program, but also to the still-working generation now paying for those benefits. Decisions made now to shore up the ailing trust fund will determine whether Social Security will survive long enough for the younger workers to take advantage of it. Unfortunately, the policy response to the current crisis seems to be leaning in the direction of providing another short-term financial fix for the system, once again postponing consideration of the politically more difficult choices affecting the program's long-term viability.

To tackle Social Security's long-term ills, policymakers must first of all come to grips with the changing demographics underlying the system. Birth rates have been going down, while mortality rates continue to improve. According to current population projections, shortly after the turn of the century, as the post-World War II baby-boom generation starts to retire, the system will face its most severe crisis. Social Security analysts estimate that by 2025, there will be roughly only two workers paying into the system for every pensioner drawing benefits. This compares with the 16-to-1 ratio of workers to retirees in 1950 and the current ratio of about 3 to 1. This radical decline in the worker-to-beneficiary ratio means that to avoid the total collapse of the system in the next century, the architects of Social Security are faced with three basic alternatives: enacting another enormous payroll tax increase, finding some other means of funding old-age income security, or acting now to trim the growth of benefits.

Another large hike in payroll taxes seems unlikely. During the days of an expanding labor force, accompanied by healthy gains in productivity and strong income growth, modest tax increases to provide more generous benefits for the elderly went largely unnoticed. But the huge tax increase approved in 1977—the largest peacetime tax hike in U.S. history—was not well received by the American public. As provided by the 1977 law, scheduled tax increases throughout the 1980s and 1990s will boost not only payroll tax rates but also the maximum level up to which a worker's earnings can be taxed. Based on Social Security Administration projections, maximum employee contributions for Social Security (which are matched by employers) will go up by almost 77% over the next five years alone. The strong public protest elicited by the 1977 increase—which its proponents had promised would "guarantee" the financial solvency of the Social Security system through 2030—may indicate that the American taxpayer's tolerance for higher payroll taxes has neared its limit.

As for a new method of funding old-age income security, one of the more controversial ideas—yet one that has a fair amount of Congressional support—is to finance the retirement program with the general revenues of the U.S. Treasury. Opponents of such a recommendation fear that this would reduce all incentives to keep the system within some bounds of actuarial balance. Still, a number of economists have argued in favor of transferring to general budget financing only those Social-Security-provided benefits not related to an individual's work experience—Medicare hospital benefits, for example. This would bolster the long-term fiscal soundness of the system while better focusing it on what it was initially intended to do.

Despite the political debate spurred by the Reagan administration proposals, the time may now be right for consideration of the third basic avenue for reform: taking a close, careful look at Social Security benefits and the purposes they serve. A recent news poll reported that more persons now favor some reduction of benefits over another increase in payroll taxes as a means of saving the retirement system. One suggestion gaining increasing support is gradually boosting the age of eligibility for full retirement benefits to 68 from its present level of 65. Retirees and future retirees, however, deserve plenty of advance notice of any reforms that will directly affect the benefits they receive. This makes prompt action on the long-term problems of Social Security all the more critical.

Diana Bailey

Asia and Oceania — Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS: 6 months ending	EXPORTS: 12-month change	GNP IN 1980: in billions of dollars	GNP IN 1980: per capita	BALANCE OF PAYMENTS: latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments
Asia	Bangladesh	Political situation casts uncertainty over future direction of economic policy.	Dec.	+ 6%	12.5*	$ 138	May	235	— 15%	1.2	275	Large overhang of stocks, soft U.S. housing market depress jute prices.
Asia	Burma	Favorable crops help government maintain nearly constant consumer price level.	Mar.	+ 22%	5.6*	174	May	267	— 5%	8.5	32	Record rice output estimated will boost exports.
Asia	China, People's Republic	Strong growth of light industry offsets decline in heavy industrial production.	June	+ 15%	517.0**	510	Dec.	2,527	— 5%	1.6	957	Despite machinery import cuts, first-half trade gap hit $500 million.
Asia	Hong Kong	Stock market continues to advance, despite some slackening in industrial sector.	Mar.	+ 13%	20.8	4,105	n. a.	—	—	—	—	Export trends spotty; recession, currency movements hurt EC sales.
Asia	India	Aid donors pledge $3.45 billion for fiscal 1981-82.	Jan.	— 3%	172.6*	257	Jan.	6,995	— 8%	6.5	311	Wheat imports to resume as govt. domestic procurement falls below target.
Asia	Indonesia	With surge in oil earnings, Pertamina launches huge refinery and petrochemical projects.	Nov.	+ 23%	63.2	417	May	6,105	+123%	6.7	0	Oil and gas output rising; export prices firm despite glut.
Asia	Japan	Momentum increasingly likely to come from domestic factors, especially consumer spending.	Apr.	+ 30%	1,043.8	8,938	May	27,283	+ 32%	2.2	0	Current account should deteriorate in second half as imports rise.
Asia	Korea	Slow but steady economic recovery proceeding, with export industries leading.	Apr.	+ 23%	57.8	1,513	Apr.	2,942	+ 17%	1.4	953	ASEAN tour by Chun may stimulate trade with Southeast Asia.
Asia	Malaysia	Most economic posts unchanged under new prime minister; policy shifts likely to be minor.	Jan.	— 1%	22.8	1,659	Mar.	4,204	+ 13%	4.4	0	Soft oil price, low prices for other exports narrow trade surplus.
Asia	Pakistan	Real economic growth estimated at 5.7% in fiscal 1980-81.	Mar.	+ 22%	28.1*	351	May	1,021	+ 17%	2.3	518	Strong remittances held 1980-81 current-account gap near year-earlier level.
Asia	Philippines	Government aid funds aid some distressed firms, but liquidity problems still widespread.	Feb.	+ 22%	35.9	750	May	2,449	+ 0%	3.7	826	Prices of main export commodities appear stabilized at low levels.
Asia	Singapore	Policy of raising industrial wages will be eased this year.	Mar.	+ 18%	10.5	4,390	Feb.	6,787	+ 14%	3.1	0	New govt. investment corporation aims to boost earnings from reserves.
Asia	Sri Lanka	Power restrictions lifted with arrival of monsoon.	Dec.	+ 2%	4.1	279	Mar.	240	— 42%	1.4	227	SDR 37.5 million drawn under resumption of IMF Extended Fund Facility.
Asia	Taiwan	Government continues efforts to attract high-technology, with slow results.	Mar.	+ 21%	40.2	2,278	n. a.	—	—	—	—	Exports slacken owing to revived Korean competition and European recession.
Asia	Thailand	New IMF standby agreement conditioned on more austere fiscal and monetary policies.	Mar.	+ 1%	32.2	693	May	1,236	— 42%	1.5	128	July 15 devaluation of 8.7% expected to spur exports.
Oceania	Australia	Sporadic labor strikes persist, constraining otherwise heated economy.	Apr.	+ 3%	137.7	9,360	May	2,864	+ 49%	1.5	72	Government liberalizes capital outflows to counter record inflows.
Oceania	New Zealand	Wages rising more rapidly than prices and productivity.	Mar.	+ 9%	21.2*	6,714	May	391	— 1%	0.9	108	Terms of trade decline.
Oceania	Papua New Guinea	Largest syndicated loan obtained on highly favorable terms.	Dec.	— 5%	2.2**	722	Mar.	350	— 29%	3.8	6	Weak commodity export prices generate current-account deficit.

	COUNTRIES	MONEY AND BANKING: 12-month changes, latest data	consumer prices	latest data	money supply (M1)	exchange rate in U.S. dollars, July 29, 1981	change from year earlier	current monetary conditions	COUNTRIES
Asia	Bangladesh	Mar.	+12%	Feb.	+22%	.0630	—11%	Domestic credit likely to be curbed.	Bangladesh
Asia	Burma	Mar.	+ 0%	Sept.'79	+14%	.1350	—15%	Black market premium on kyat reported declining.	Burma
Asia	China, People's Republic	Dec.	+ 8%	n. a.	—	.5700	—16%	Treasury bonds sold to reduce money supply growth.	China, People's Republic
Asia	Hong Kong	Mar.	+13%	Mar.	+17%	.1740	—14%	Rates rise one percentage point as HK dollar slips.	Hong Kong
Asia	India	Feb.	+13%	Sept.	+ 2%	.1125	—13%	Restrictive monetary measures taken to fight inflation.	India
Asia	Indonesia	Apr.	+17%	Dec.	+46%	.001595	— 2%	Central bank continues heavy gold purchases.	Indonesia
Asia	Japan	May	+ 5%	Mar.	— 4%	.004202	— 7%	Domestic factors preclude rate hikes despite weak yen.	Japan
Asia	Korea	Apr.	+26%	Mar.	+20%	.0015	—12%	Won depreciation since end-1980 less than 4%.	Korea
Asia	Malaysia	Mar.	+ 9%	Mar.	+14%	.4245	— 9%	Ringgit remains firm through change of government.	Malaysia
Asia	Pakistan	Mar.	+14%	Mar.	+15%	.1020	—30%	Deficit financing to be held to about 2% of GDP.	Pakistan
Asia	Philippines	Apr.	+10%	Mar.	+10%	.1300	— 5%	Most interest rate ceilings lifted July 1.	Philippines
Asia	Singapore	Apr.	+ 7%	Feb.	+ 5%	.4635	— 2%	Private credit demand strong; money growth rapid.	Singapore
Asia	Sri Lanka	Apr.	+18%	Mar.	+21%	.0585	— 8%	Reserve requirements raised; credit restricted.	Sri Lanka
Asia	Taiwan	Mar.	+21%	Mar.	+14%	.0290	0	Use of bank loans for stock transactions prohibited.	Taiwan
Asia	Thailand	Mar.	+15%	Dec.	+13%	.0475	— 6%	Bank loan ceiling lifted to 19% from 18%.	Thailand
Oceania	Australia	Mar.	+ 9%	Mar.	+11%	1.1395	— 1%	Capital inflows heighten inflationary pressures.	Australia
Oceania	New Zealand	Mar.	+15%	Mar.	+10%	.8320	—15%	Government actively taps Euro-market for funds.	New Zealand
Oceania	Papua New Guinea	Mar.	+11%	Mar.	—18%	n. a.	—	Prime rate raised two percentage points to 14.5%.	Papua New Guinea

*Fiscal year **1979

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World Interest Rates

market rates of July 29, 1981; bond yields as of July 24, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	19.89	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	17.75 July 30	20.00	12.75	7.65	18.125	12.00	20.00	1[illegible].50	1.00	7.375
Treasury Bills 91-day, Middle Rates	15.15 discount basis	20.875	13.75	16.25	n. a.	n. a.	18.451 92-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	16.75 finance paper discount basis	21.25 finance paper 15% tax w/h	12.949	12.90 Certified	17.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.25	21.25 15% tax w/h	13.9375	12.90 Certified	not traded	9.90	23.15	no market	9.625	no market
Government Bonds Long-term, new and old issues, average yield	13.84	17.50	14.85	11.135 20% tax w/h	n. a.	10.63	20.46	11.63	5.52	8.341
Industrial Bonds prime, long-term, new and old issues, average yield	14.60 Aa Industrials	18.25	16.02	16.95	n. a.	11.20	20.69	12.17	6.275	7.27
Bank Short-Term Rate to Best Borrowers (prime rate)	20.50	21.00	13.00	18.00	19.60	14.50	22.50 ⅛ quar'ly fee on outstdng.	14.00	9.50	6.75
Bank Time Deposits 3-month	17.625 Cert. of Dep.	20.30	14.375	15.50	17.50	12.75	10.75	13.50 large deposits	8.50 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.9375	no market	14.625	no market	22.375	12.75	no market	13.4375	9.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8147	1.8525	.0248	.1716	.4062	.00082	.3659	.4710	.004202
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	4.00 *P*	3.00 *D*	3.00 *D*	6.00 *P*	12.00 *D*	5.00 *P*	6.00 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
July 30

7-day	19.00
1-month	19.00
3-month	19.00
6-month	18.875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.4114
U.S.-Canada Treasury Bills	−2.42
U.S.-Canada Finance Co. Paper	−2.208
Eurodollars-U.K. Local Auth. Deposits	n. a.

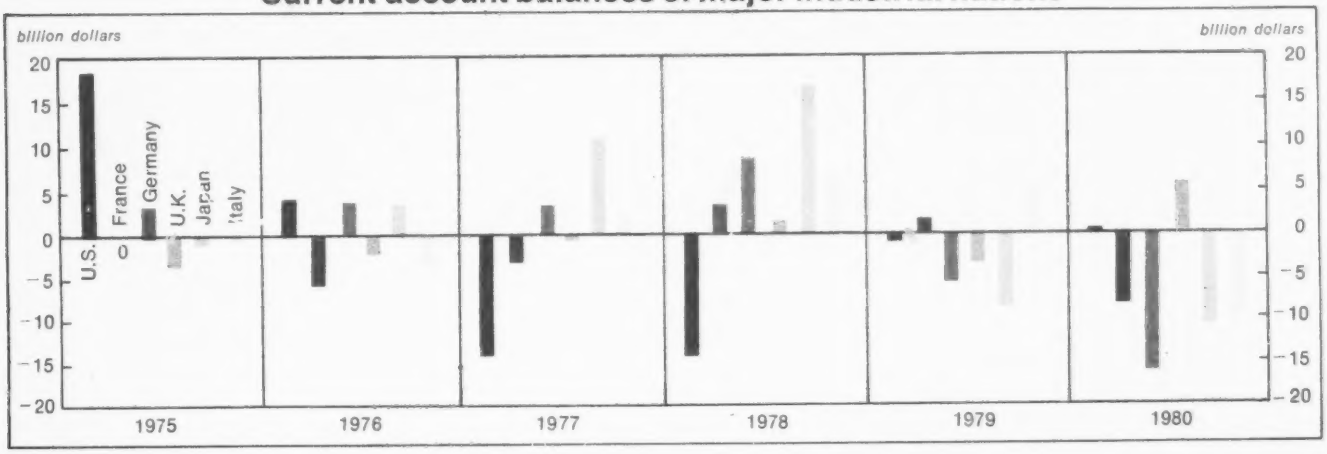
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	16.00
Over 7 yrs.	15.50
DM Bonds	
7 yrs. and under	11.50
Over 7 yrs.	10.625

Gold Price
London afternoon fixing
402.25*
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* July 30.

Current account balances of major industrial nations



U.K. Revising Monetary Control Techniques

The Bank of England has recently announced proposals to change some of the rules governing the operations of the London money markets and of the 500 or so banks participating in them. Changes in money-market rules are significant for their relative rarity and for their wide-reaching and sometimes unforeseen effects. The latest proposals are essentially an acknowledgement of the U.K. monetary authorities' problems with controlling the money supply—an objective that has assumed great importance under the leadership of Prime Minister Thatcher.

The Bank of England's decision to alter U.K. money-market rules must take many variables into account—including its sometimes conflicting mandates. First, the bank must fulfill its role as the guardian of the financial system, ensuring that institutions operating in the market are properly managed and observe sensible guidelines to limit their risks. Second, the bank must serve as banker to the British government and must ensure that the government's very large financing needs (the budget deficit is now running at 7% of GNP) are met on favorable terms. And third, the central bank has to implement the government's monetary policies.

Very often these three central bank roles tend to conflict, necessitating a compromise in terms of money-market rules. For example, a tightening of monetary conditions may curb the London market's appetite for government paper, which increases the government's difficulty in financing the deficit. Also, tight monetary polices may mean high interest rates, which increase the cost of servicing the government's debt and raise its borrowing requirement.

The stock of money is usually measured by sterling M3, defined as cash in circulation plus the sterling bank deposits of all U.K residents. Sterling M3 has consistently grown faster than government intentions, despite large rises in interest rates and, at times, quantitative controls on banks. The central bank was thus faced with two alternatives in redesigning money-market rules: to seek better ways of controlling sterling M3 and/or to reexamine theory and practice to determine whether sterling M3 is an appropriate measure of the money supply.

There is certainly a strong case for choosing another money-supply measure. Sterling M3 was well above its target range in 1980, even though the British economy showed many signs of tight money. Nominal interest rates were high, the exchange rate appreciated sharply, and—given the inflexibility of wages—output fell below its 1979 level. Indeed, some of the other measures of the money stock—both broader and narrower—grew much less rapidly than sterling M3, which has led many observers to call for a different measure.

Also casting doubt on the validity of such traditional money-stock measures as sterling M3 are developments that have superseded the suspension of foreign-exchange controls in November 1979. Since the suspension, British residents have been free to export sterling, to buy assets abroad, and to hold foreign currencies. Recent statistics show that, as a result, there has been a large increase in residents' holdings of foreign currencies. Such holdings, however, are not included in sterling M3.

Further complicating matters has been the severity of the recession in the United Kingdom, which has reduced the government's tax revenue well below its planned figure while increasing its expenditure on social security payments as well as its subsidies to the nationalized industries. As a result, the expanding budget deficit and its financing problems are compounding the difficulty of controlling money growth.

It is against this background that the Bank of England issued consultative documents proposing changes in money-market rules. In light of the market's reactions to these documents, details have been refined and the market now awaits the new rules' implementation. The new guidelines are widely expected to become effective on August 20, but it is still possible that the current proposals will be modified or that implementation of some or all parts will be postponed.

Many of the consultative papers published by the central bank deal with the management of foreign-currency exposure—an area that has become more important since the suspension of exchange controls. The changes in the rules pertaining to foreign-currency exposure will be important to the management of the banks in London, but they are unlikely to mean any great changes for monetary conditions and, hence, for the behavior of interest rates and the sterling exchange rate. Of greater importance to the international marketplace will be the changes that are proposed in the techniques of monetary control.

New control techniques explained

The discussion of methods of monetary control in the United Kingdom has centered on the money-stock measure to be used in targeting money growth and on the best techniques to be used to control the chosen measure. On the first issue, the central bank has reaffirmed that sterling M3 will remain the prime tool of monetary policy, but that account will be taken of other aggregates as well. Thus, the course of M1 and M3 (equal to sterling M3 plus U.K. residents' foreign-currency deposits at banks) will continue to be watched closely. In addition, the central bank has

U.K. Revising Monetary Control Techniques *(continued from page 7)*

introduced two new measures that provide more details of private-sector liquidity: PSL1, defined as the private-sector component of sterling M3 plus holdings of other money-market instruments, such as deposits with local authorities and finance houses and certificates of tax deposits; and PSL2, defined as PSL1 plus private-sector savings deposits with such institutions as building societies and savings banks. These various measures often move in different directions, so that by focusing its attention on one rather than another, the central bank can have considerable freedom of action.

As for better controlling the chosen money-stock measure, the Bank of England has made it clear that, beginning in August, it intends to operate on the monetary base (banks' deposits with the Bank of England) as a means of controlling the important aggregates. So far, the central bank has backed away from an entirely mandatory system under which banks must follow clear-cut rules. It is suggested only that all banks deposit ½% of their liabilities as cash balances at the Bank of England while leaving banks to make their own decisions on many of the assets that they hold against their liabilities. (However, many observers expect an announcement very soon that all banks must also deposit 6% of their eligible liabilities with the discount houses.)

As for its own strategy, the central bank proposes to make several alterations in its day-to-day operations. Greater emphasis will be placed on open-market operations at the expense of discount-window (lender-of-last-resort) lending. The open-market operations will aim to keep very short-term interest rates within a band determined by the authorities' monetary objectives. The upper and lower limits of the band would not be published, but the central bank would hint at them by charging a rate on its discount-window lending somewhat above comparable market rates but still within the unpublished band. At some stage, the central bank would probably stop announcing a Minimum Lending Rate (the old "bank rate"), as it would have no particular significance.

Assessing the impact

It appears virtually certain that during the initial stages, interest rates and sterling's exchange rate will be more volatile than previously as a result of the new changes. This is because the Bank of England will have to learn as it goes along, but, more important, it is because a lot of "central-bank-watching" is likely to emerge as the market searches for clues about the bank's day-to-day intentions. As in the United States, excessive attention will probably be given to short-term fluctuations, triggering gross over-reactions by the market. Given the present weakness of sterling and the uncertainty over government policy, it appears likely that the first of the volatile movements will see interest rates climb rather than drop.

Over the longer run, the practical effects of the changes are likely to be smaller than a theoretical presentation would suggest. It is clear that no government can set independent targets for the growth of nominal GNP, for the growth of the money stock, and for the structure of interest rates—as has been demonstrated by recent U.S. experience. It follows that if the authorities stick rigidly to a desired growth of GNP and the money stock, they are forced to allow interest rates to move to market-clearing levels. The British government, however, has found that when it has tried to control the growth of the money stock, the market-clearing interest-rate levels tend to be higher than it can accept. This is partly because of political considerations but also because the resulting levels are incompatible with other components of economic policy, such as management of the government debt and the exchange rate. Thus, a compromise is often reached whereby the money stock is allowed to overshoot and the rise in interest rates is checked. The overshooting has sometimes been quite overt; at other times, the authorities have imposed quantitative controls—such as the "corset" mechanism—that artificially depress the chosen money-stock measure relative to other measures and so disguise the extent to which overshooting is actually occurring.

This process is very likely to continue under the new regime. The Bank of England has deliberately left its proposals riddled with loopholes. It has chosen to allow banks to make their own decisions about the *prudent* level of reserves, so that the size—of the stability—of the money multiplier cannot be predicted in advance. In addition, the monetary authorities have indicated not only that they will watch more than one money-stock measure, but also that they may change at any time the relative weights they attach to each. Thus, an overshooting in one or more measures may or may not be a signal that conditions in the money markets are about to be changed. Finally, by refusing to publish its target interest-rate band and allowing itself to charge a rate at its discount window anywhere within the band, the central bank will avoid giving any clear indication of its views on the existing level of interest rates.

In sum, there is likely to be little substantive change in money market trends as a result of the new measures. Increased volatility around those trends can be expected, however, and this implies a higher risk for market participants that may require compensation in the form of somewhat higher average real interest rates.

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